S&P Global Ratings

Credit FAQ:

Fonterra's Restructuring Is A Painful Step To Recovery

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New Zealand-based Fonterra Group Cooperative Ltd. (A-/Stable/A-2) is implementing a credible deleveraging plan and has reasonable prospects of building a rating buffer over the next 12 to 18 months. S&P Global Ratings expects Fonterra's strategic review to result in more disciplined allocation of capital and more robust operational performance. Still, balance sheet repair and operating performance will remain immediate priorities for the dairy cooperative, in our view.

In our opinion, Fonterra somewhat lost its way over the past seven years. S&P Global Ratings lowered the credit rating on two separate occasions (August 2014 and October 2015). While each downgrade was precipitated by discrete events, the common undercurrent was the cooperative's ambitious capital investment program that sought to grow Fonterra beyond its core function of collecting, processing, and selling New Zealand milk.

1. Why is Fonterra's outlook stable when debt levels remain elevated?

We believe Fonterra has a credible deleveraging plan and reasonable prospects of building a rating buffer over the next 12 to 18 months. The new leadership is forthright in its acknowledgement of the challenges confronting the cooperative and the scale of the task ahead. The suspension of dividends and adjustment of the milk price indicate the group is willing to actively protect the interest of creditors, which we view as broadly analogous to the long-term sustainability of the cooperative.

We expect Fonterra's strategic review to result in more disciplined allocation of capital and more robust operational performance. Structural changes to Fonterra’s vertically-integrated, farmer-only cooperative structure are unlikely to be contemplated at this stage--indeed, we believe the cooperative's core functions of collecting, processing, and selling New Zealand milk remains fundamentally sound.

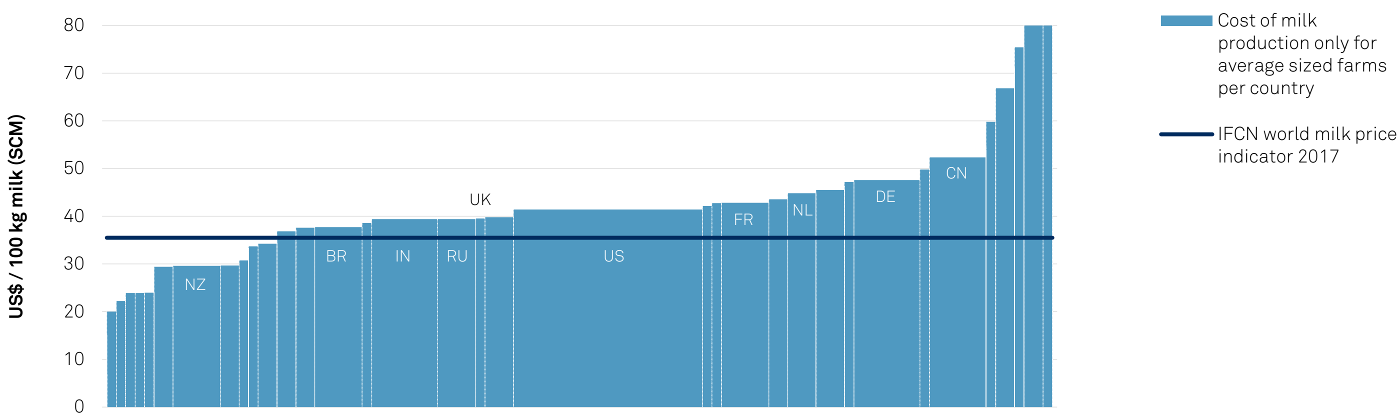
In our opinion, the revised strategy is likely to emphasize value over volume and core capabilities over adjacencies. We expect a simplified strategy that focuses on global competitiveness over volume, recognizing the capital constraints inherent within the cooperative model. All options appear to be on the table. Balance sheet repair and operating performance will remain immediate priorities regardless.

The divestment of noncore or underperforming assets should promote earnings stability with proceeds applied to reduce debt. Lower capital expenditure and more stable working capital will also help repair the balance sheet. In addition, we believe the cooperative has made good progress in restructuring its operating cost base and is committed to better transparency, forecasting, and performance monitoring.

In our opinion, Fonterra has maintained its global market leadership, dominance in the purchase of raw milk in New Zealand, and position as the lowest cost, large-scale producer globally. That said, we are mindful of execution risks and any wavering of the cooperative's commitment to restoring its financial health would put immediate downward pressure on the 'A-' rating.

Chart 1

Global Milk Supply Cost Curve



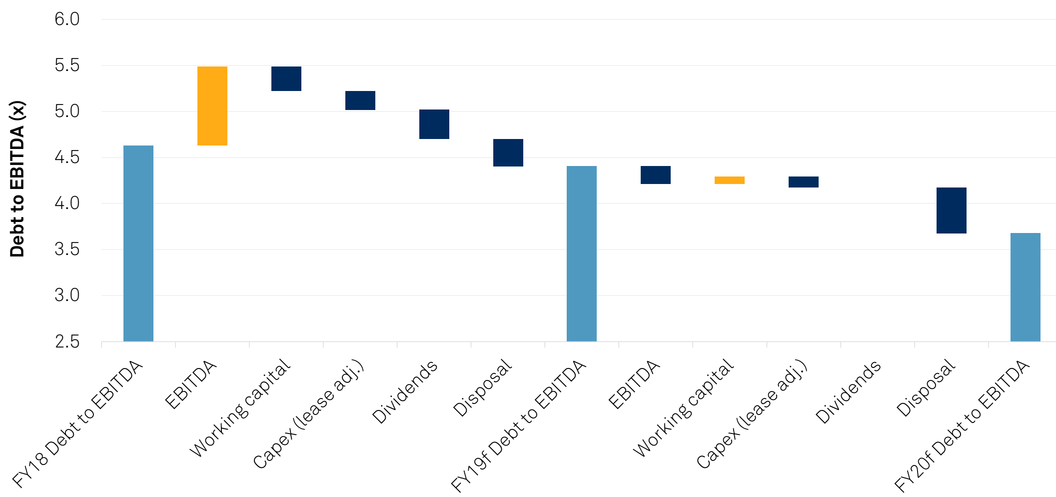
SCM--solid corrected milk. IFCN-- international farm comparison network. Source: IFCN, S&P Global Ratings.

2. What are S&P Global Ratings' forecasts?

We forecast asset divestments, reductions in capital expenditure, better working capital management, and some earnings normalization to restore Fonterra's debt-to-EBITDA ratio below 4x within the next few months. While the cooperative's leverage will remain above its downward ratings trigger at the July 2019 balance date, the deleveraging timetable is still broadly consistent with past expectations. We monitor the cooperative's debt-to-asset target only to the extent that it indicates financial risk appetite.

Chart 2

Illustrative Debt-To-EBITDA Forecast Bridge



f--Forecast. Source: Company reports, S&P Global Ratings.

During the financial year ended July 31, 2019, Fonterra completed the following divestments:

- Tip Top ice cream company: NZ$380 million, announced May 13, 2019 (settled in fiscal 2019); and
- Foodspring nutrition business: NZ$64 million premium to book value, announced June 28, 2019 (settled in fiscal 2020).

We understand that the disposal of Fonterra's 50% stake in DFE Pharma is in its advanced stage. We expect sale proceeds to meaningfully reduce debt. Fonterra has also signaled its intention to divest its 18.8% shareholding in Beingmate, but has not been able to find a buyer for its entire stake. Any on-market sale process will be complicated by local listing rules that require a gradual sell-down that could last a number of years.

Fonterra and Nestle also intend to sell their Dairy Partners Americas (DPA) Brazil joint venture, in which Fonterra holds a 51% interest, which we also expect to be completed during fiscal 2020. We believe additional divestments are likely, but have not been factored them into our base case operating scenario.

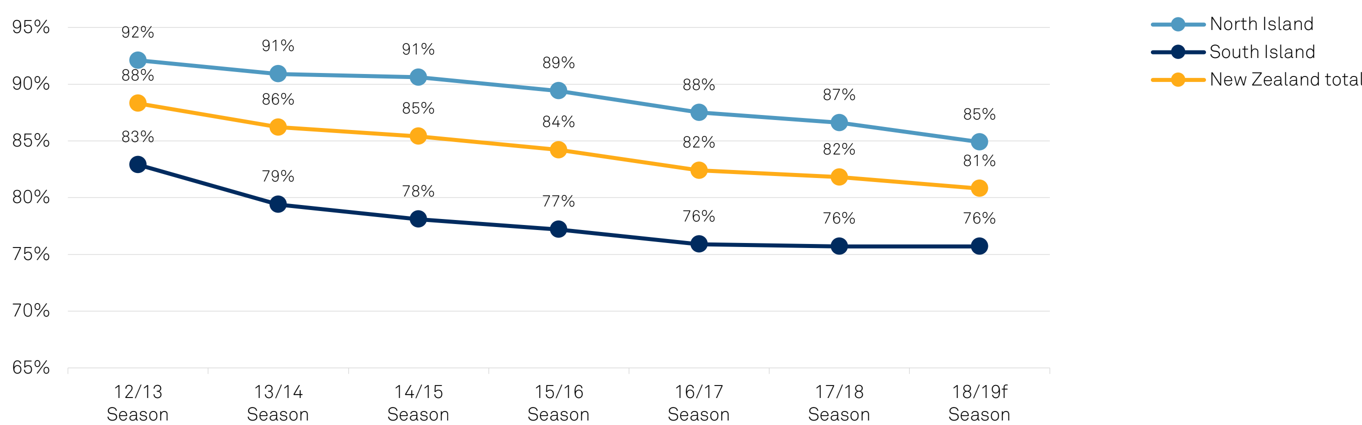
Capital expenditure is forecast to materially reduce to NZ$650 million in fiscal 2019, and we believe there is scope for further reduction. In our opinion, capital expenditure not exceeding NZ$500 million per annum is achievable during the forecast years (see chart 4). A more commercially-orientated research and development function should also support the cooperative's long-term profitability.

That said, Fonterra's credit metrics remain most sensitive to earnings changes. Our base-case operating scenario incorporates some normalization of earnings supported by increased cost discipline, better execution of strategy, and asset-level returns more commensurate with invested capital. We forecast the realization of performance initiatives incrementally. Over a longer time horizon, we are mindful of structural challenges that include:

- Competition for milk collections within New Zealand;
- Fonterra's regulated "open entry" and competitor supply obligations;
- Shareholder farmers' stretched balance sheets and difficulties "sharing-up"; and
- The possibility of more onerous environmental constraints.

Chart 3

Fonterra's New Zealand Milk Collections



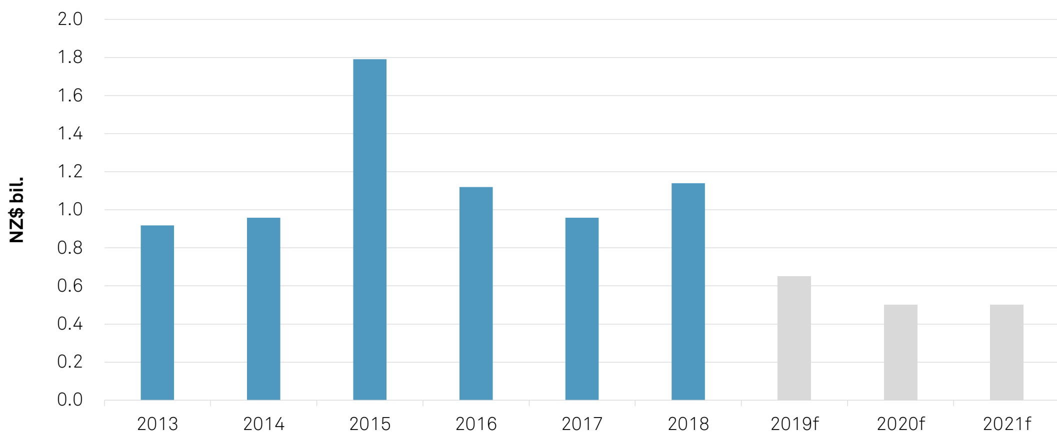
f--Forecast. Source: Company reports, S&P Global Ratings.

3. What caused Fonterra's balance-sheet pressure?

In our opinion, Fonterra somewhat lost its way over the past seven years. S&P Global Ratings lowered the credit rating on two separate occasions (August 2014 and October 2015). While each downgrade was precipitated by discrete events, the common undercurrent was the cooperative's ambitious capital investment program that sought to grow Fonterra beyond its core function of collecting, processing, and selling New Zealand milk.

Chart 4

Fonterra’s Capital Expenditure



f--Forecast. Source: Company reports, S&P Global Ratings.

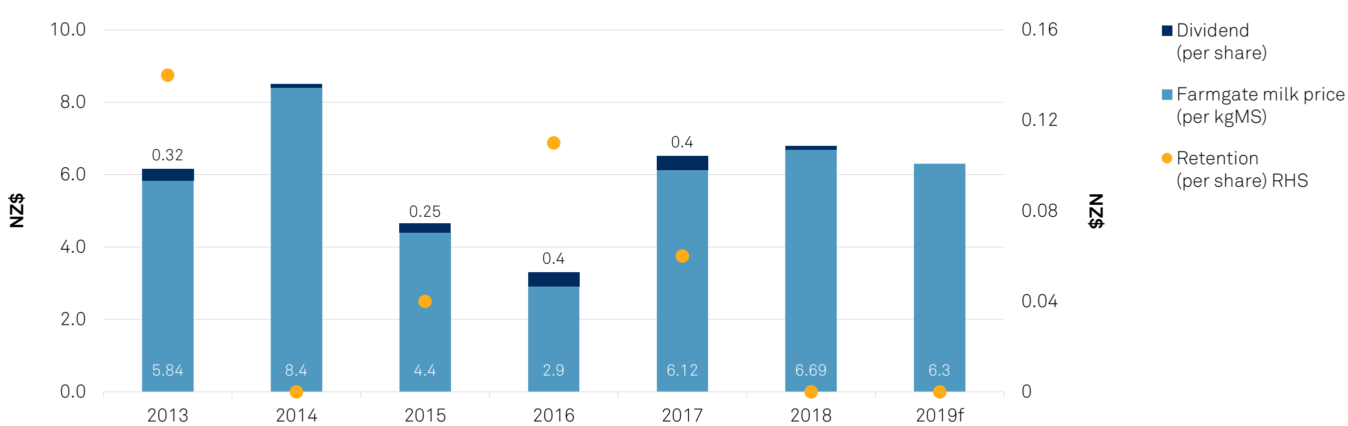
This investment cycle was predicated upon the cooperative's belief that unconstrained global demand would surpass New Zealand's milk supply. In response, Fonterra embarked on a strategy to build global scale by investing in offshore milk pools and processing capacity in New Zealand to accommodate significant milk supply growth. This occurred during a period when the cooperative was also investing in higher-value specialized ingredients and consumer and food services.

The result was a step-change in organic and acquisition-led growth that pressured Fonterra's balance sheet. At the same time, operating costs increased and dividend payments remained high. In our opinion, the balance sheet could have absorbed any one of these factors. However, it was the combination of factors that stretched Fonterra's balance sheet.

Fonterra is predominantly reliant on debt funding and earnings retentions since its cooperative structure partly constrains access to third-party equity capital. High shareholder returns inherent within cooperative structures also limit cash flow retention.

Chart 5

Shareholder Farmers’ Historical Returns



f--Forecast. MS--milk solids. Source: Company reports, S&P Global Ratings.

Fonterra proved less adept at generating sustainable returns in more capital-intensive and product-differentiated markets. Tougher trading conditions brought to the surface the misallocation of capital. Rising milk prices reduced margins and increased working capital demands, predominantly inventory. For example, sustained competition in the Greater China's foodservice market and constraints in certain Asian markets limited Fonterra's ability to fully pass through higher input costs.

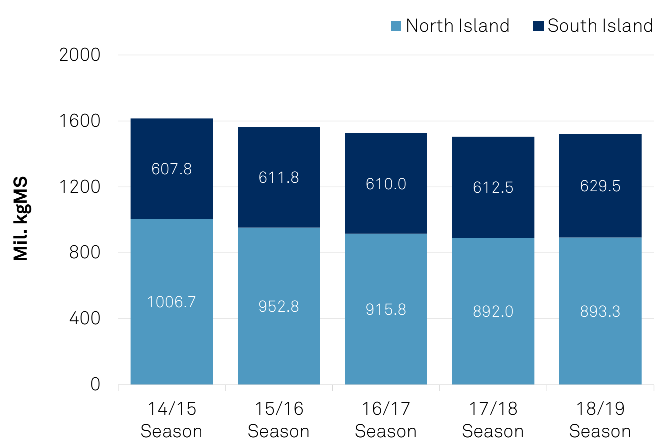
Fonterra's capital investment program failed to live up to expectations. Asset write-downs, such as those the cooperative announced on Aug. 12, 2019, are symptomatic of poor investment decisions or execution. Recent impairments include Beingmate, China Farms, DPA Brazil, the Australian Ingredients business, and New Zealand consumer business. In addition, exiting Venezuela resulted in a significant one-off impact predominantly regarding the release of the foreign currency translation reserve.

In retrospect, these businesses may not have warranted their level of investment. It is not unreasonable to suggest, for example, that the scale of investment in China Farms and Beingmate was not necessary for building Fonterra's strong market position in China.

Since Fonterra's establishment in 2001, milk volumes have benefited from the conversion of land to dairy, greater density of cows per hectare, and improved productivity per cow. More recently, however, volume growth stalled both domestically and abroad for a variety of cyclical reasons (such as adverse weather events) and structural reasons (such as increased competition for New Zealand milk collections and increased environmental constraints). Critical mass is necessary for Fonterra's plant utilization, for example dryers, and to mitigate the risk that assets become stranded. It is, therefore, necessary for Fonterra to remain competitive against independent processors.

Chart 6

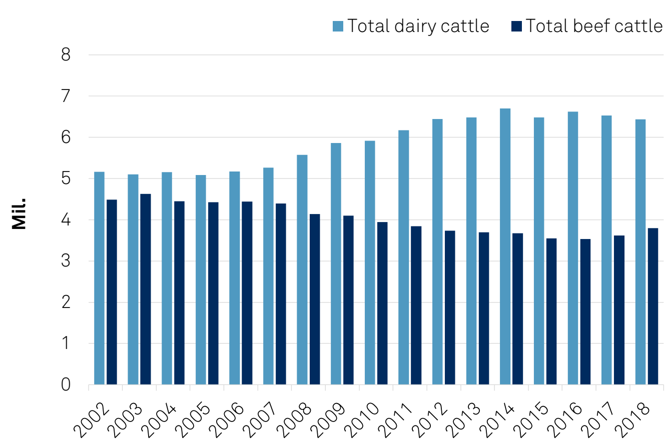
Fonterra’s New Zealand Milk Collections



MS--milk solids. Source: Company reports, S&P Global Ratings.

Chart 7

New Zealand Dairy Cattle Vs Beef Cattle



Source: Company reports, S&P Global Ratings.

There were also one-off events such as the WPC80 botulism scare that resulted in mass precautionary product recalls by Fonterra and damage claims from affected parties. A lower New Zealand dollar also affected the translation of overseas debt, partially offset by hedging. We note that recent impairment charges announced in August 2019 are noncash and do not directly affect Fonterra's fundamental credit metrics.

4. Why does Fonterra still have a higher debt capacity than similarly rated peers?

We assess Fonterra as having higher debt capacity because milk payments to its New Zealand supplier base are effectively subordinated to payments to other creditors. Fonterra has a long-established track record of exercising its discretion over these supplier payments during and at the end of the season.

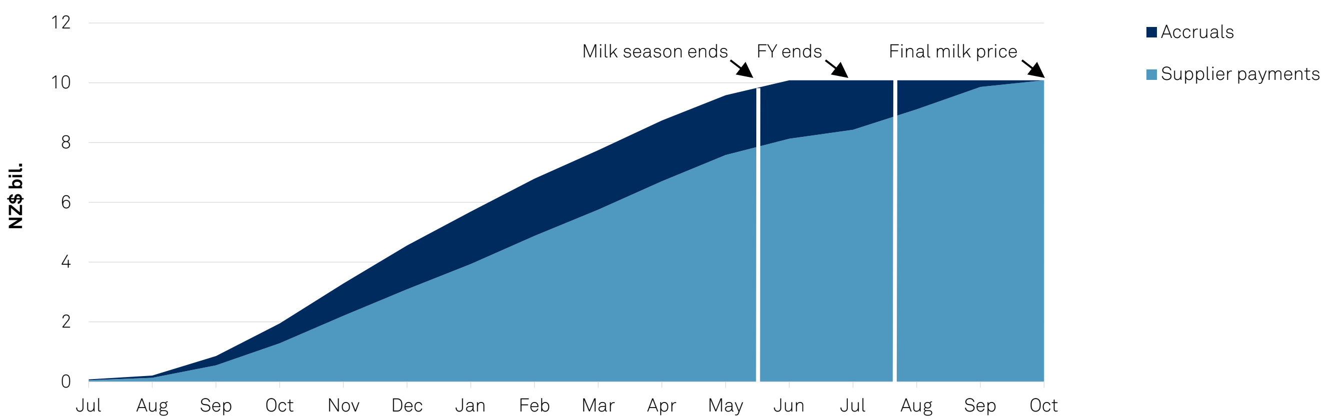
In our opinion, this structure supports debt servicing in virtually all foreseeable circumstances. We note that Fonterra's flexibility and willingness to pass through milk price changes to farmers is significantly greater than many offshore peers, where this flexibility is theoretically available but rarely demonstrated by global peers.

Fonterra's constitution provides it with the ability to reduce member payments. Milk prices are determined by the board based on the cooperative's milk price manual, a publicly available document, and the forecast milk price is published at the start of each season. Any revisions to the forecast price are publicly released.

Payments adjust to movements in global dairy product prices. An advance payment, typically around 65%-70% of forecast milk price, is made at the end of each month for milk supplied. This is followed by further payments so that 85% of the forecast is typically paid by year end. Final payment is made in October, which is around three months after financial year end, once all sales and costs are finalized.

Chart 8

Illustrative Supplier Accruals Through The Season

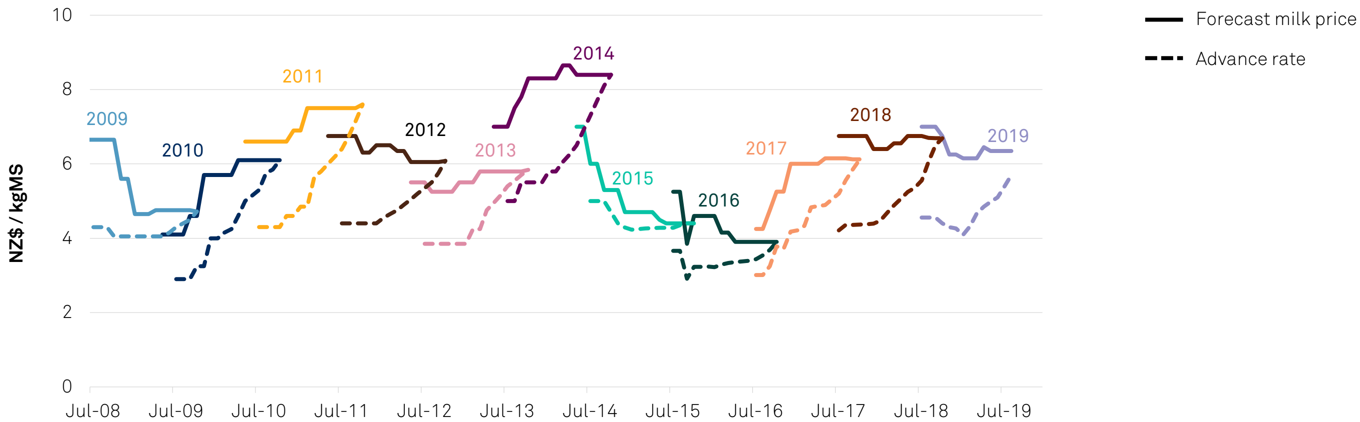


Source: Company reports, S&P Global Ratings.

Fonterra's demonstrated track record of adjusting payments is shown in the chart below. Slowing the pace of payments to farmers made a significant positive impact to cash flows in the 2009, 2015, and 2016 seasons. In addition, the board has used its discretion twice to adjust the final milk price to protect the cooperative’s balance sheet in both 2014 and 2018. We note that these adjustments were not deferrals and there is no obligation to make up payments.

Chart 9

Fonterra's Forecast Milk Price Vs Advance Rate



MS--milk solids. Source: Company reports, S&P Global Ratings.

We consider it highly probable that the cooperative would be willing and able to adjust milk payments in the future given its position as the dominant buyer of milk in New Zealand, purchasing more than 80% of milk production. However, farmers supplying Fonterra outside New Zealand are not shareholders. To this end, we believe the effective subordination of payments could be meaningfully tempered if New Zealand-sourced milk declined to around 70% of Fonterra's total global milk collection. This would imply a lower debt capacity. So, too, would any adverse changes that arise from Fonterra's current capital structure review.

5. How important are environmental, social, and governance (ESG) factors to Fonterra's creditworthiness?

Very. ESG factors are important to Fonterra and need to be managed carefully. Fonterra's cooperative structure introduces an additional layer of complexity to its governance. Management and board face intense scrutiny over their performance, and the cooperative's current financial position has drawn strong criticism from sections of its shareholder-farmer base and unit holders.

The 'A-' rating on Fonterra relies on the board and management remaining resolute in restructuring the cooperative and deleveraging its balance sheet. In our opinion, governance factors contributed to the widespread misallocation of capital.

That said, we believe Fonterra's current management and board have little attachment to its past strategy. We believe they understand the scale and complexity of the task confronting them and are willing to take the hard decisions necessary to ensure the cooperative's long-term sustainability. Moreover, in our view the current management is attentive to the concerns of its shareholder farmers and has their broad-based support to drive change. Management's ability to execute its strategy and deliver on its promises are key rating considerations.

In our opinion, Fonterra recognizes the business' social responsibility to the wider dairy farming community. Dairy products account for about one quarter of New Zealand's exports, making Fonterra somewhat of a "national champion". In recognition of Fonterra's near-monopoly position, the Dairy Industry Restructuring Act (DIRA) seeks to appropriately balance the interests of various stakeholders within the New Zealand dairy industry. The DIRA currently binds Fonterra to an "open-entry" regime for new dairy conversions and returning farmers, nationally averaged collection costs, and requires it to supply raw milk to competitors.

We note that a comprehensive review of DIRA is underway with Fonterra seeking to reduce what it considers to be unfairly onerous obligations. In our opinion, changes proposed by government appear more incremental at this stage. The review concluded that "open entry" should remain but proposed two new exceptions where Fonterra can refuse applications to supply:

- Where the farm is unlikely to comply with Fonterra’s terms of supply, including the cooperative's environmental, animal health and other requirements; and,
- Where the farm is a new conversion.

We believe that Fonterra successfully leverages New Zealand's "clean and green" image and manages environmental risks and increasingly stringent regulations inherent within the agriculture and commodity foods industry. Fonterra has a significant environmental footprint amid increasing scrutiny on greenhouse gas emissions generated by energy use and the biological emissions of cows, health and biodiversity of land and waterways, farming efficiencies and sustainability, as well as managing waste discharge. We expect proposed DIRA changes to provide Fonterra with greater scope to manage environmental outcomes across its shareholder-farmer base.

Failure to maintain strict food safety and operational measures can be harmful to consumers and result in significant damages and reputational consequences for Fonterra. Underscoring the importance of this was the WPC80 botulism scare in 2013 that resulted in mass precautionary product recalls by Fonterra and its affected customers, resulting in claims. In the case of one customer, Danone, Fonterra had to pay significant damages in accordance with an arbitration decision on the French food company's claims against Fonterra. Animal health and biosecurity are treated seriously, as highlighted by Fonterra's response to "mycoplasma bovis" bacteria detected in the Canterbury region in 2017.

We believe that Fonterra is working with shareholder farmers to actively address environmental factors. However, many of the measures require significant capital outlay that may place additional financial pressure on the cooperative as well as its shareholder farmers. In our view, upstream environmental factors weigh on volume growth, which affects the throughput and operating efficiency of its processing plants.